

# ***California Housing Loan Insurance Fund***

*Financial Statements and Supplementary  
Information for the Years Ended  
December 31, 2006 and 2005, and  
Independent Auditors' Report*

## INDEPENDENT AUDITORS' REPORT

To the Board of Directors  
California Housing Finance Agency  
Sacramento, California

We have audited the accompanying balance sheets of the California Housing Loan Insurance Fund (the "Fund"), which is administered by the California Housing Finance Agency (the "Agency"), a component unit of the State of California, as of December 31, 2006 and 2005, and the related statements of revenues, expenses, and changes in fund equity, and of cash flows for the years then ended. The accompanying financial statements are the statements of the Fund and do not include the financial position or the results of the operations of the Agency. These financial statements are the responsibility of the management of the Agency. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Fund as of December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Agency's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an opinion on it.

*Deloitte + Touche LLP*

April 20, 2007

# **CALIFORNIA HOUSING LOAN INSURANCE FUND**

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL POSITION AND RESULTS OF OPERATIONS YEARS ENDED DECEMBER 31, 2006 AND 2005**

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The California Housing Finance Agency (the "Agency") was created in 1975 by an act of the California Legislature and commenced operations in 1976. The Agency is a component unit of the State of California (the "State") and is included in the State's Comprehensive Annual Financial Report. The Agency is authorized to administer the activities of the California Housing Loan Insurance Fund (the "Fund"), the California Housing Finance Fund (the "CHFF"), and two State general obligation bond funds. The following Management Discussion and Analysis applies only to the activities of the California Housing Loan Insurance Fund and should be read in conjunction with the Fund's financial statements and the notes to the financial statements. The Agency is entirely self-funded and does not draw upon the general taxing authority of the State.

The Agency is authorized to use the Fund's assets as at-risk capital in support of mortgage insurance programs which finance the acquisition, new construction, or rehabilitation of residential structures in California. The Fund insures loans made by the Agency; loans made by lenders for securitization by the Federal National Mortgage Association (the "FNMA"), and Federal Home Loan Mortgage Corporation (the "FHLMC"); and loans made by localities, nonprofit agencies, and the California State Teachers' Retirement System. In conducting business the Agency is authorized to reinsure any risk undertaken by the Fund.

While the Fund is subject to the same statutory requirements as private mortgage insurance companies with respect to the maintenance of policyholders' surpluses, the Fund is exempt from regulatory control by the State Department of Insurance. The claims-paying ability of the Fund has been assigned a rating of A+ by Standard & Poor's.

Underwriting, acquisition, and issuance expenses are charged directly to the Fund as well as loss and loss adjustment expenses. Certain administrative and operating expenses, including office space, business services and supplies, legal services, accounting services, information technology support, and human resource support services, are provided by the Agency and indirectly charged to the Fund.

### **Financial Highlights 2006 – 2005**

- Insurance in force has increased by \$857 million, or 75%, to \$2 billion as of December 31, 2006, compared to \$1.14 billion as of December 31, 2005. This increase in insured loans is primarily due to an increased proportion of Agency loans the Fund had insured this year.
- Home mortgage delinquencies and foreclosures have been surging nationally in recent months, especially for people who took out subprime mortgages. In response to rising concern of risks of increasing foreclosures, the Agency has increased its reserve for loan losses by \$155,000 to \$534,000 as a result of the Fund's increase in insurance in force and higher loss reserves required to cover potential delinquencies. The Agency continues to monitor delinquencies closely and is proactive in its attempts to mitigate losses.
- New insurance written was \$1.05 billion during fiscal year 2006 compared to \$655 million during fiscal year 2005. The \$395 million increase is primarily a result of a continued emphasis on the Agency's programs.

- Continuing the trend since fiscal year 2001 and largely due to the rapid price appreciation of homes in California, insurance claims activity remained at very low levels. Insurance claim payments were \$107,500 and \$22,100 in fiscal years 2006 and 2005, respectively.
- The Fund continued the services of the reinsurance treaty and administrative services agreement with Genworth Financial (“Genworth”), previously known as GE Mortgage Insurance Corporation (GEMICO). This insurance treaty cedes to Genworth a 75% quota share of the insurance risk and 64.5% of the premium collected for most loans insured by the Fund.
- Operating income increased \$2.7 million to \$5.2 million during fiscal year 2006 compared to operating income of \$2.5 million during fiscal year 2005. The Fund remains financially strong and has fund equity of \$64.6 million at December 31, 2006, compared with \$59.4 million in 2005.

### **Fiscal Year 2006 Compared to Fiscal Year 2005**

#### **Condensed Balance Sheets**

The following table presents condensed balance sheets for the Fund as of December 31, 2006 and 2005, and the change from year to year (dollars in thousands):

	<b>2006</b>	<b>2005</b>	<b>Change</b>
<b>ASSETS</b>			
Cash, cash equivalents, and investments	\$ 64,096	\$ 58,842	\$ 5,254
Other assets	<u>2,591</u>	<u>1,940</u>	<u>651</u>
<b>TOTAL ASSETS</b>	<b><u>\$ 66,687</u></b>	<b><u>\$ 60,782</u></b>	<b><u>\$ 5,905</u></b>
<b>LIABILITIES AND FUND EQUITY</b>			
<b>LIABILITIES:</b>			
Unpaid losses and loss adjustment expenses	\$ 534	\$ 379	\$ 155
Unearned premiums	384	484	(100)
Accounts payable and other liabilities	<u>1,147</u>	<u>522</u>	<u>625</u>
<b>Total liabilities</b>	<b>2,065</b>	<b>1,385</b>	<b>680</b>
<b>FUND EQUITY:</b>			
Invested in capital assets	4	6	(2)
Restricted by statute	<u>64,618</u>	<u>59,391</u>	<u>5,227</u>
<b>Total fund equity</b>	<b><u>64,622</u></b>	<b><u>59,397</u></b>	<b><u>5,225</u></b>
<b>TOTAL LIABILITIES AND FUND EQUITY</b>	<b><u>\$ 66,687</u></b>	<b><u>\$ 60,782</u></b>	<b><u>\$ 5,905</u></b>

**Assets**—Total assets of the Fund were \$66.7 million as of December 31, 2006, an increase of \$5.9 million or 10% from December 31, 2005. Of the Fund’s assets, more than 96% are represented by cash and investments. The Fund does not have a significant investment in capital assets.

Cash and investments were \$64 million as of December 31, 2006, an increase of \$5.3 million from December 31, 2005. The increase is primarily due to an increase in premiums earned and investment income. The Agency invests the Fund's cash in the State's Surplus Money Investment Fund ("SMIF"). SMIF provides the Fund a variable rate of return and complete liquidity. Cash invested in SMIF is deposited within the State's Centralized Treasury System and managed by the State Treasurer.

Other assets were \$2.6 million as of December 31, 2006, an increase of \$651,000 or 34% from December 31, 2005. The increase is the result of more interest receivable and accounts receivable from premiums.

**Liabilities**—The Fund's liabilities were \$2.1 million as of December 31, 2006, an increase of \$680,000 or 49% from December 31, 2005.

The reserve for unpaid losses and loss adjustment expenses were \$534,000 as of December 31, 2006, an increase of \$155,000 from December 31, 2005. The increase in the loss reserve is the result of the Fund's increase in insurance in force and higher loss reserves required to cover potential delinquencies. As of December 31, 2006, 132 insured loans with balances aggregating \$31 million were either reported as delinquent by the lender or delinquent but not reported, while 93 insured loans with balances aggregating \$17.2 million were reported or delinquent and not reported by lenders as of December 31, 2005.

Unearned premiums were \$384,000 as of December 31, 2006, a decrease of \$100,000 from December 31, 2005. The decrease in unearned premiums is the continuation of an expected trend due to a change in premium collection practices. Beginning in 1996, management adopted the mortgage insurance industry norm of collecting monthly premium payments in arrears for newly established loan insurance products as compared to past practices of collecting annual premiums in advance. As a result, each year a greater percentage of insured loans require monthly premium payments, which are earned when received, rather than annual payments, which are received in advance and deferred and earned over a one-year period.

Accounts payable and other liabilities were \$1,147,000 as of December 31, 2006, an increase of \$625,000 from December 31, 2005. This increase is largely attributable to amounts owed to the reinsurer and due to the CHFF for administration costs.

**Fund Equity**—All of the Fund's equity is restricted or invested in capital assets. The Fund's equity is restricted pursuant to the Agency's enabling legislation. Total equity of the Fund grew by \$5.2 million as a result of increased premiums earned and investment income.

## Condensed Statements of Revenues and Expenses

The following table presents condensed statements of revenues and expenses for the Fund for the fiscal years ended December 31, 2006 and 2005, and the change from year to year (dollars in thousands):

	2006	2005	Change
OPERATING REVENUES:			
Premiums earned	\$ 12,405	\$ 7,081	\$ 5,324
Investment income	2,858	1,732	1,126
Other revenues	<u>230</u>	<u></u>	<u>230</u>
Total operating revenues	<u>15,493</u>	<u>8,813</u>	<u>6,680</u>
OPERATING EXPENSES:			
Loss and loss adjustment expenses	190	76	114
Operating expenses	10,076	6,211	3,865
Other expenses (benefits)	<u>2</u>	<u>3</u>	<u>(1)</u>
Total operating expenses	<u>10,268</u>	<u>6,290</u>	<u>3,978</u>
OPERATING INCOME	<u>\$ 5,225</u>	<u>\$ 2,523</u>	<u>\$ 2,702</u>

**Operating Revenues**—Operating revenues were \$15.5 million during fiscal year 2006 compared to \$8.8 million during fiscal year 2005, an increase of \$6.7 million or 76%.

Premiums earned in fiscal year 2006 increased by \$5.3 million or 75% compared to premiums earned in fiscal year 2005. The increase in premiums earned corresponds with the increase in insurance in force. Insurance in force was \$2 billion and \$1.14 billion as of December 31, 2006 and 2005, respectively.

Investment income increased \$1.1 million to \$2.9 million in fiscal year 2006 from \$1.7 million in fiscal year 2005. This increase was due to the increase in the investment portfolio and the increase in interest rates. SMIF interest rates for the past two years are shown in the following table:

<u>Interest Payment Periods</u>	<u>Fiscal Year 2006</u>	<u>Interest Payment Periods</u>	<u>Fiscal Year 2005</u>
January - March	4.032 %	January - March	2.373 %
April - June	4.529	April - June	2.851
July - September	4.926	July - September	3.178
October - December	5.106	October - December	3.626

**Operating Expenses**—Total operating expenses were \$10.3 million during fiscal year 2006 compared to \$6.3 million during fiscal year 2005, an increase of \$4 million or 63%.

Loss and loss adjustment recoveries increased by \$114,000. The increase is attributable to the increase of new insurance written for higher loan sizes and the increase in required reserves to cover potential delinquencies.

The Fund's operating expenses were \$10.1 million during fiscal year 2006 compared to \$6.2 million during fiscal year 2005, an increase of \$3.9 million or 61%. The increase is primarily in ceded premiums to the reinsurer.

**Operating Income**—Operating income for fiscal year 2006 was \$5.2 million compared to \$2.5 million in fiscal year 2005, an increase of \$2.7 million. The increase in operating income is a result of the increase of earned premiums and an increase in investment income.

## **Fiscal Year 2005 Compared to Fiscal Year 2004**

### **Condensed Balance Sheets**

The following table presents condensed balance sheets for the Fund as of December 31, 2005 and 2004, and the change from year to year (dollars in thousands):

	<b>2005</b>	<b>2004</b>	<b>Change</b>
<b>ASSETS</b>			
Cash, cash equivalents, and investments	\$ 58,842	\$ 55,583	\$ 3,259
Other assets	<u>1,940</u>	<u>1,929</u>	<u>11</u>
<b>TOTAL ASSETS</b>	<b><u>\$ 60,782</u></b>	<b><u>\$ 57,512</u></b>	<b><u>\$ 3,270</u></b>
<b>LIABILITIES AND FUND EQUITY</b>			
<b>LIABILITIES:</b>			
Unpaid losses and loss adjustment expenses	\$ 379	\$ 320	\$ 59
Unearned premiums	484	923	(439)
Accounts payable and other liabilities	<u>522</u>	<u>354</u>	<u>168</u>
<b>Total liabilities</b>	<b>1,385</b>	<b>1,597</b>	<b>(212)</b>
<b>FUND EQUITY:</b>			
Invested in capital assets	6	9	(3)
Restricted by statute	<u>59,391</u>	<u>55,906</u>	<u>3,485</u>
<b>Total fund equity</b>	<b><u>59,397</u></b>	<b><u>55,915</u></b>	<b><u>3,482</u></b>
<b>TOTAL LIABILITIES AND FUND EQUITY</b>	<b><u>\$ 60,782</u></b>	<b><u>\$ 57,512</u></b>	<b><u>\$ 3,270</u></b>

**Assets**—Total assets of the Fund were \$60.8 million as of December 31, 2005, an increase of \$3.3 million or 6% from December 31, 2004. Of the Fund's assets, more than 96% are represented by cash and investments. The Fund does not have a significant investment in capital assets.

Cash and investments were \$58.8 million as of December 31, 2005, an increase of \$3.3 million from December 31, 2004. The increase is primarily due to an increase in premiums earned, the additional draw of Prop 46 funds, and investment income. The Agency invests the Fund's cash in the State's SMIF. SMIF provides the Fund a variable rate of return and complete liquidity. Cash invested in SMIF is deposited within the State's Centralized Treasury System and managed by the State Treasurer.

Other assets were \$1.9 million as of December 31, 2005, and were equal to the amount as of December 31, 2004.

**Liabilities**—The Fund’s liabilities were \$1.4 million as of December 31, 2005, a decrease of \$212,000 or 13% from December 31, 2004.

The reserve for unpaid losses and loss adjustment expenses were \$379,000 as of December 31, 2005, an increase of \$59,000 from December 31, 2004. The increase in the loss reserve is the result of the Fund’s increase in insurance in force and higher loss reserves required to cover potential delinquencies. As of December 31, 2005, 93 insured loans with balances aggregating \$17.2 million were either reported as delinquent by the lender or delinquent but not reported, while 96 insured loans with balances aggregating \$12.7 million were reported or delinquent and not reported by lenders as of December 31, 2004.

Unearned premiums were \$484,000 as of December 31, 2005, a decrease of \$439,000 from December 31, 2004. The decrease in unearned premiums is the continuation of an expected trend due to a change in premium collection practices. Beginning in 1996, management adopted the mortgage insurance industry norm of collecting monthly premium payments in arrears for newly established loan insurance products as compared to past practices of collecting annual premiums in advance. As a result, each year a greater percentage of insured loans require monthly premium payments, which are earned when received, rather than annual payments, which are received in advance and deferred and earned over a one-year period.

Accounts payable and other liabilities were \$522,000 as of December 31, 2005, an increase of \$168,000 from December 31, 2004. This increase is largely attributable to amounts owed to the reinsurer.

**Fund Equity**—All of the Fund’s equity is restricted or invested in capital assets. The Fund’s equity is restricted pursuant to the Agency’s enabling legislation. Total equity of the Fund grew by \$3.5 million as a result of increased premiums earned and investment income.

### Condensed Statements of Revenues and Expenses

The following table presents condensed statements of revenues and expenses for the Fund for the fiscal years ended December 31, 2005 and 2004, and the change from year to year (dollars in thousands):

	2005	2004	Change
OPERATING REVENUES:			
Premiums earned	\$ 7,081	\$ 5,926	\$ 1,155
Investment income	1,732	872	860
Other revenues	<u>          </u>	<u>13</u>	<u>(13)</u>
Total operating revenues	<u>8,813</u>	<u>6,811</u>	<u>2,002</u>
OPERATING EXPENSES:			
Loss and loss adjustment expenses (recoveries)	76	(450)	526
Operating expenses	6,211	7,089	(878)
Other expenses (benefits)	<u>3</u>	<u>4</u>	<u>(1)</u>
Total operating expenses	<u>6,290</u>	<u>6,643</u>	<u>(353)</u>
OPERATING INCOME	<u>\$ 2,523</u>	<u>\$ 168</u>	<u>\$ 2,355</u>

**Operating Revenues**—Operating revenues were \$8.8 million during fiscal year 2005 compared to \$6.8 million during fiscal year 2004, an increase of \$2 million or 29%.



Premiums earned in fiscal year 2005 increased by \$1.2 million or 19% compared to premiums earned in fiscal year 2004. The increase in premiums earned corresponds with the increase in insurance in force. Insurance in force was \$1.14 billion and \$796 million as of December 31, 2005 and 2004, respectively.

Investment income increased \$860,000 to \$1.7 million in fiscal year 2005 from \$872,000 in fiscal year 2004. This increase was due to the increase in the investment portfolio and the increase in interest rates. SMIF interest rates for the past two years are shown in the following table:

<u>Interest Payment Periods</u>	<u>Fiscal Year 2005</u>	<u>Interest Payment Periods</u>	<u>Fiscal Year 2004</u>
January - March	2.373 %	January - March	1.467 %
April - June	2.851	April - June	1.441
July - September	3.178	July - September	1.665
October - December	3.626	October - December	1.995

**Operating Expenses**—Total operating expenses were \$6.3 million during fiscal year 2005 compared to \$6.6 million during fiscal year 2004, a decrease of \$353,000 or 6%.

Loss and loss adjustment expenses increased by \$526,000. The increase is attributable to the increase of new insurance written for higher loan sizes and the increase in required reserves to cover potential delinquencies.

The Fund's operating expenses were \$6.2 million during fiscal year 2005 compared to \$7.1 million during fiscal year 2004, a decrease of \$878,000 or 13%. The decrease is primarily attributable to the decrease in staff charges and litigation expenses.

**Operating Income**—Operating income for fiscal year 2005 was \$2.5 million compared to \$168,000 in fiscal year 2004, an increase of \$2.4 million. The increase in operating income is a result of the increase of earned premiums, increase in investment income, and reduction in litigation expenses.

# CALIFORNIA HOUSING LOAN INSURANCE FUND

## BALANCE SHEETS

DECEMBER 31, 2006 AND 2005

	2006	2005
<b>ASSETS</b>		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 20,060	\$ 36,639
Investment in Surplus Money Investment Fund	64,076,000	58,805,000
Interest receivable	816,412	536,547
Other current assets	<u>1,581,188</u>	<u>1,171,230</u>
Total current assets	66,493,660	60,549,416
NONCURRENT ASSETS—Other assets	<u>193,471</u>	<u>232,366</u>
TOTAL	<u>\$66,687,131</u>	<u>\$60,781,782</u>
<b>LIABILITIES AND FUND EQUITY</b>		
CURRENT LIABILITIES:		
Reserves for unpaid losses and loss adjustment expenses	\$ 534,186	\$ 379,131
Unearned premiums	321,525	385,121
Reinsurance payable	547,074	321,993
Accounts payable and other liabilities	84,913	21,632
Due to California Housing Finance Fund	<u>514,955</u>	<u>178,496</u>
Total current liabilities	2,002,653	1,286,373
NONCURRENT LIABILITIES—Unearned premiums	<u>62,649</u>	<u>98,402</u>
Total liabilities	<u>2,065,302</u>	<u>1,384,775</u>
CONTINGENCIES (Note 9)		
FUND EQUITY:		
Invested in capital assets	4,132	6,253
Restricted by statute	<u>64,617,697</u>	<u>59,390,754</u>
Total fund equity	<u>64,621,829</u>	<u>59,397,007</u>
TOTAL	<u>\$66,687,131</u>	<u>\$60,781,782</u>

See notes to financial statements.

# CALIFORNIA HOUSING LOAN INSURANCE FUND

## STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN FUND EQUITY YEARS ENDED DECEMBER 31, 2006 AND 2005

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	2006	2005
OPERATING REVENUES:		
Premiums earned	\$ 12,404,598	\$ 7,080,605
Investment income	2,858,109	1,732,468
Other revenues	<u>229,778</u>	<u></u>
Total operating revenues	<u>15,492,485</u>	<u>8,813,073</u>
OPERATING EXPENSES:		
Loss and loss adjustment expenses (net of recoveries)	189,380	75,802
Operating expenses	10,076,162	6,211,082
Other expenses—net	<u>2,121</u>	<u>3,086</u>
Total operating expenses	<u>10,267,663</u>	<u>6,289,970</u>
OPERATING INCOME	5,224,822	2,523,103
TRANSFER FROM PROP 46 (Note 8)		958,903
FUND EQUITY—Beginning of year	<u>59,397,007</u>	<u>55,915,001</u>
FUND EQUITY—End of year	<u>\$ 64,621,829</u>	<u>\$ 59,397,007</u>

See notes to financial statements.

# CALIFORNIA HOUSING LOAN INSURANCE FUND

## STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 2006 AND 2005

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts from customers	\$ 11,848,862	\$ 6,270,912
Payments to suppliers	(9,275,097)	(5,736,457)
Payments to employees	(431,438)	(424,407)
Internal activity—payments from other funds	336,459	730,260
Other receipts (payments)	<u>197,391</u>	<u>(18,156)</u>
Net cash provided by operating activities	<u>2,676,177</u>	<u>822,152</u>
CASH FLOWS PROVIDED BY RELATED FINANCING ACTIVITIES—Transfer from Prop 46 (Note 8)	<u></u>	<u>958,903</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from sale of investments	1,850,000	1,568,000
Purchase of investments	(7,121,000)	(4,823,000)
Interest on investments	<u>2,578,244</u>	<u>1,477,594</u>
Net cash used in investing activities	<u>(2,692,756)</u>	<u>(1,777,406)</u>
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(16,579)	3,649
CASH AND CASH EQUIVALENTS—Beginning of year	<u>36,639</u>	<u>32,990</u>
CASH AND CASH EQUIVALENTS—End of year	<u>\$ 20,060</u>	<u>\$ 36,639</u>
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating income	\$ 5,224,822	\$ 2,523,103
Adjustments to reconcile operating income to net cash provided by operating activities:		
Interest on investments	(2,858,109)	(1,732,468)
Unpaid loss and loss adjustment expenses	155,055	59,108
Depreciation expense	2,121	3,086
Deferred policy acquisition expense	332,519	315,315
Changes in certain operating assets and liabilities:		
Other assets	(705,703)	(626,652)
Unearned premiums	(99,349)	(439,350)
Reinsurance payable	225,081	55,433
Accounts payable and other liabilities	63,281	(65,683)
Due to California Housing Finance Fund	<u>336,459</u>	<u>730,260</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>\$ 2,676,177</u>	<u>\$ 822,152</u>

See notes to financial statements.

# CALIFORNIA HOUSING LOAN INSURANCE FUND

## NOTES TO FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 2006 AND 2005

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### 1. AUTHORIZING LEGISLATION AND ORGANIZATION

The California Housing Loan Insurance Fund (the “Fund”) is one of two continuously appropriated funds administered by the California Housing Finance Agency (the “Agency”). The Agency was created by the Zenovich-Moscone-Chacon Housing and Home Finance Act (the “Act”), as amended, as a public instrumentality, a political subdivision, and a component unit of the State of California (the “State”), and is in the State’s Annual Financial Report and administers the activities of the Fund and the California Housing Finance Fund (the “CHFF”). These funds allow the Agency to carry out its purpose of meeting the housing needs of persons and families of low and moderate income within the State. The Agency is authorized to insure mortgage loans and to issue bonds, notes, and other obligations to fund loans to qualified borrowers for single-family houses and multifamily developments. The Agency has no taxing power and is exempt from federal income taxes and state franchise taxes.

The accompanying financial statements are the statements of the Fund and do not include the financial position or the results of operations of the Agency. As of June 30, 2006, the Agency had total assets of \$9.5 billion and fund equity of \$1.3 billion (not covered by this independent auditors’ report).

The Agency is also authorized to use the Fund to provide mortgage insurance for loans made by the Agency and others which finance the acquisition, new construction, or rehabilitation of residential structures in California. Total risk in-force was \$770 million and \$499 million at December 31, 2006 and 2005, respectively. More than 82% of the insured first mortgage loans outstanding at December 31, 2006, have loan-to-value ratios, measured as of the funding date of the loan, equal to or greater than 90%.

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

***Basis of Presentation and Accounting***—The Fund is accounted for as an enterprise fund. Accordingly, the accompanying financial statements have been prepared using the accrual method of accounting and on the basis of accounting principles generally accepted in the United States of America (hereinafter referred to as “Generally Accepted Accounting Principles”), which differ from statutory accounting practices followed by insurance companies in reporting to insurance regulatory authorities.

***Accounting and Reporting Standards***—The Fund follows the Standards of Governmental Accounting and Financial Reporting, as promulgated by the Governmental Accounting Standards Board (“GASB”). The Fund has adopted the option under GASB Statement No. 20, which allows the Fund to apply all GASB pronouncements and only Financial Accounting Standards Board (“FASB”) pronouncements which date prior to November 30, 1989.

***Use of Estimates***—The preparation of financial statements in conformity with Generally Accepted Accounting Principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

***Cash and Cash Equivalents***—The Fund considers cash on hand and cash on deposit with the State Controller’s office other than the investment in the State’s Surplus Money Investment Fund (“SMIF”) to be cash and cash equivalents.

***Investments***—The Agency invests the Fund’s excess cash in SMIF, which represents a portion of the State’s Pooled Money Investment Account (“PMIA”). These PMIA funds are on deposit within the State’s Centralized Treasury System and are managed in compliance with the California Government Code, according to a statement of investment policy which sets forth permitted investment vehicles, liquidity parameters, and maximum maturity of investments. Investments in SMIF are recorded at fair value. The Office of the State Treasurer of California issues a Pooled Money Investment Board Report with information on the PMIA’s portfolio composition. A copy of that report may be obtained from the Office of the State Treasurer, 915 Capitol Mall, Room 106, Sacramento, CA 95814 or via the internet at [www.treasurer.ca.gov](http://www.treasurer.ca.gov).

***Deferred Policy Acquisition Costs***— The Fund defers certain costs related to the acquisition of new insurance policies and amortizes these costs over the expected life of the policies. These costs are associated with the acquisition, underwriting, and processing of new policies. Deferred policy acquisition costs were \$416,677 and \$497,941 as of December 31, 2006 and 2005, respectively, and are included as part of other assets on the balance sheets.

***Reserves for Unpaid Losses and Loss Adjustment Expenses***—The Fund establishes reserves for losses and loss adjustment expenses, to recognize the estimated liability for potential losses and related loss expenses in connection with borrower default on mortgage payments. The liability for unpaid losses and loss adjustment expenses resulting from mortgage insurance is an estimate based upon the unpaid delinquent balance on mortgage loans reported by lenders as of the close of the accounting period, estimates of incurred but not reported (“IBNR”) claims and historical and expected frequency and loss severity information.

There is a high level of uncertainty inherent in the evaluation of the required loss and loss adjustment expense reserves. Management has selected frequency of claims paid and severity loss ratios that it believes are reasonable and reflective of anticipated ultimate experience. The ultimate costs of claims are dependent upon future events, the outcomes of which are affected by many factors. The Fund’s claim-reserving procedures and settlement practices, economic inflation, court rulings, real estate market conditions, and many other economic, scientific, legal, political, and social factors all can have significant effects on the ultimate cost of claims.

Changes in operations and management practices may also cause actual developments to vary from past experience. Since the emergence and disposition of claims are subject to uncertainties, the net amounts that will ultimately be paid to settle the liability may vary significantly from the estimated amounts provided for in the accompanying financial statements. Any adjustments that may be material to reserves are reflected in the operating results of the periods in which they are made.

***Fund Equity***—Fund equity is classified as invested in capital assets or restricted equity. Invested in capital assets represents investments in office equipment and furniture net of depreciation. Restricted Equity represents equity that is restricted pursuant to the Agency’s enabling legislation.

***Operating Revenues and Expenses***—The Fund’s primary operating revenue is derived from premiums earned on private mortgage insurance written. The primary expenses are the expenses associated with the underwriting, acquisition, issuance, administration, and the reinsurance of private mortgage insurance products and policies.

**Recognition of Premium Income**—Primary mortgage insurance policies are contracts that are generally noncancelable by the insurer and provide payment of premiums on a monthly, annual, or single basis. Premiums written on a monthly basis are earned as coverage is provided. Premiums written on an annual basis are deferred as unearned premiums and amortized on a monthly pro rata basis over the year of coverage. Primary mortgage insurance premiums written on policies covering more than one year are referred to as single premiums. A portion of single premiums is recognized immediately in earnings, and the remaining portion is deferred as unearned premiums and amortized over the expected life of the policy.

**Reinsurance**—Effective March 1, 2003, the Fund entered into a reinsurance treaty and administrative services agreement with Genworth Financial (“Genworth”). This agreement cedes to Genworth a 75% quota share of the insurance risk for most loans insured by the Fund and provides for certain administrative services to be performed by Genworth. The Fund uses reinsurance to reduce net risk in force and optimize capital allocation.

**Recent Accounting Pronouncements**—In December 2004, GASB issued FASB Statement No. 46, *Net Assets Restricted by Enabling Legislation—an amendment of GASB Statement No. 34*, effective for periods beginning after June 15, 2005. GASB Statement No. 46 clarifies that a legally enforceable enabling legislation restriction is one that a party external to a government—such as citizens, public interest groups, or the judiciary—can compel a government to honor. The statement states that the legal enforceability of an enabling legislation restriction should be reevaluated if any of the resources raised by the enabling legislation are used for a purpose not specified by the enabling legislation or if a government has other cause for reconsideration. The Fund adopted the new standard for the fiscal year beginning January 1, 2006. Adoption of this standard did not have any material effect on the Fund’s financial statements.

### 3. INVESTMENT RISK FACTORS

There are many factors that can affect the value of investments. Some, such as credit risk, custodial credit risk, concentration of credit risk, and interest rate risk, may affect both equity and fixed income securities. Equity and debt securities respond to such factors as economic conditions, individual company earning performance, and market liquidity, while fixed income securities are particularly sensitive to credit risks and changes in interest rates. It is the investment policy of the Fund to invest substantially all of its funds in fixed income securities, which limits the Fund’s exposure to most types of risk.

Investments by type at December 31, 2006 and 2005, consist of the following:

	2006	2005
Surplus Money Investment Fund—State of California	<u>\$ 64,076,000</u>	<u>\$ 58,805,000</u>
Total Investments	<u>\$ 64,076,000</u>	<u>\$ 58,805,000</u>

**Credit Risk**—Fixed income securities are subject to credit risk, which is the chance that a issuer will fail to pay interest or principal in a timely manner or that negative perceptions of the issuer’s ability to make these payments will cause security prices to decline. Certain fixed income securities, including obligations of the U.S. government or those explicitly guaranteed by the U.S. government, are not considered to have credit risk. At December 31, 2006, the Fund does not have any investments exposed to credit risk.

***Custodial Credit Risk***—Custodial credit risk is the risk that in the event of the failure of the custodian, the investments may not be returned. At December 31, 2006, the Fund did not have any investments exposed to custodial credit. All investments are held by the State of California.

***Concentration of Credit Risk***—Concentration of credit risk is the risk associated with a lack of diversification, such as having substantial investments in a few individual issuers, thereby exposing the Fund to greater risks resulting from adverse economic, political, regulatory, geographic, or credit developments. At December 31, 2006, the Fund does not have any investments exposed to concentration of credit risk.

***Interest Rate Risk***—Interest rate risk is the risk that the value of fixed income securities will decline due to decreasing interest rates. The terms of a debt investment may cause its fair value to be highly sensitive to interest rate changes. At December 31, 2006, the Fund does not have any debt investments that are highly sensitive to changes in interest rates.

***Effective Duration***—The effective duration is the approximate change in price of a security resulting from a 100 basis points (1 percentage point) change in the level of interest rates. It is not a measure of time. The Fund's investments are not affected by effective duration.



#### 4. RESERVES FOR UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES

The following tables summarize the changes in the reserves for unpaid losses and loss adjustment expenses for the years ended December 31, 2006 and 2005. The first table presents reserves on a gross basis (before reinsurance) and the second table presents the reserve on a net basis (after reinsurance). The total net reserve for loss and loss adjustment is reflected in the financial statements.

<b>Gross</b>	<b>2006</b>	<b>2005</b>
Gross reserve for loss and loss adjustment—beginning of year balance	<u>\$ 1,428,856</u>	<u>\$ 943,548</u>
Incurred (recovered) related to:		
Provision attributable to the current year	1,870,152	1,133,893
Change in provision attributable to prior years	<u>(1,058,185)</u>	<u>(626,491)</u>
Total incurred	811,967	507,402
Payments related:		
Current year	(98,901)	
Prior years	<u>(8,634)</u>	<u>(22,094)</u>
Total payments	<u>(107,535)</u>	<u>(22,094)</u>
Gross reserve for loss and loss adjustment—end of year balance	<u>\$ 2,133,288</u>	<u>\$ 1,428,856</u>
<b>Net of Reinsurance</b>	<b>2006</b>	<b>2005</b>
Net reserve for loss and loss adjustment—beginning of year balance	<u>\$ 379,131</u>	<u>\$ 320,023</u>
Incurred (recovered) related to:		
Provision attributable to the current year	467,558	283,016
Change in provision attributable to prior years	<u>(278,178)</u>	<u>(207,214)</u>
Total incurred	189,380	75,802
Payments related:		
Current year	(32,167)	(11,170)
Prior years	<u>(2,158)</u>	<u>(5,524)</u>
Total payments	<u>(34,325)</u>	<u>(16,694)</u>
Net reserve for loss and loss adjustment—end of year balance	<u>\$ 534,186</u>	<u>\$ 379,131</u>

Reserves for loss and loss adjustment expenses relate to delinquent loans, net of reinsurance. Such estimates were based on historical experience, which management believed was representative of expected future losses at the time of estimation. As a result of the extended period of time that may exist

between the report of a delinquency and claim payment thereon, significant uncertainty and variation exist with respect to the ultimate amount to be paid because economic conditions and real estate markets will change.

## **5. REINSURANCE**

Effective March 1, 2003, the Fund entered into a 75% quota-share reinsurance agreement with Genworth to reinsure 98% of the Funds portfolio. Under the terms of this agreement, the reinsurer will indemnify the Fund for 75% of all losses paid on the insured loans to which the Fund cedes 64.5% of the related premiums. The Fund's reinsurance agreement typically provides for a recovery of a proportionate level of claim expenses from the reinsurer. The Fund remains liable to its policyholders if the reinsurer is unable to satisfy its obligations under the reinsurance agreement. The amount of earned premiums ceded to Genworth for the years ended 2006 and 2005 was \$7.9 million and \$4.3 million, respectively.

## **6. ARRANGEMENTS WITH THE CALIFORNIA HOUSING FINANCE FUND**

Certain of the administrative and operating expenses charged to the Fund are provided by the Agency. These expenses, initially paid from the CHFF, include office space, business services, legal services, accounting services, information systems support, and human resource support services. The Fund is charged quarterly for these expenses. Amounts payable to the CHFF were \$735,106 and \$377,555 at December 31, 2006 and 2005, respectively. The increase in the amount payable at December 31, 2006, was due to a change in the reimbursement procedures. Total amounts receivable from the CHFF were \$220,151 and \$199,059 at December 31, 2006 and 2005, respectively. For the years ended December 31, 2006 and 2005, total expenses allocated to the Fund by the Agency were \$1,247,481 and \$1,255,000, respectively.

The Agency Board of Directors approved Resolution 03-19 on March 20, 2003, authorizing the Agency to utilize the resources of CHFF to support the mortgage guaranty insurance programs of the Agency in the following two ways: (1) the Executive Director of the Agency is authorized to create one or more supplementary reserve accounts within the Supplementary Bond Security Account of CHFF to indemnify the Mortgage Insurance Fund for losses incurred or to pay claims against the Mortgage Insurance Fund in connection with loans financed by the Agency and (2) the Executive Director of the Agency may establish an interfund credit agreement by which the Fund may borrow such sums from CHFF as may be required to maintain the claims paying rating of any credit rating service.

Subsequently, the Agency Executive Director established an interfund credit agreement in the amount of \$100,000,000 in which the Fund may borrow from CHFF as needed for the purpose of paying claims arising out of policies of mortgage guarantee insurance and costs and expenses related to the payment of such claims. Interest rates and repayment terms are determined upon receipt of a request to draw on this credit facility. The Fund had not requested a draw on this credit through December 31, 2006.

## **7. PENSION PLAN**

The Fund contributes to the Public Employees' Retirement Fund ("PERF") as part of the State of California, the primary government. The PERF is a cost-sharing multiple-employer defined benefit pension plan administered by the California Public Employment Retirement System ("CalPERS"). CalPERS provides retirement, death, disability, and postretirement health care benefits to members as established by state statute. CalPERS issues a publicly available Comprehensive Annual Financial

Report (“CAFR”) that includes financial statements and required supplementary information for the Public Employees’ Retirement Fund. A copy of that report may be obtained from CalPERS, Central Supply, and P.O. Box 942175, Sacramento, CA 95229-2715 or via the internet at [www.calpers.ca.gov](http://www.calpers.ca.gov).

For the CalPERS fiscal years ended June 30, 2007, 2006, and 2005, the employer contribution rates were as follows:

	Fiscal Year Ended		
	June 30, 2007	June 30, 2006	June 30, 2005
State Miscellaneous Member First Tier	16.997 %	15.942 %	17.022 %
State Miscellaneous Member Second Tier	16.778	15.890	13.216

The Fund’s contributions to the PERF for the years ended December 31, 2006, 2005, and 2004, were \$94,440, \$104,062, and \$109,919, respectively, equal to the required contributions for each year.

Required contributions are determined by actuarial valuation using the individual entry age normal cost method. The most recent actuarial valuation available is as of June 30, 2006, which actuarial assumptions included (a) 7.75% investment rate of return compounded annually, (b) projected salary increases that vary by duration of service, and (c) overall payroll growth factor of 3.25% annually. Both (a) and (c) included an inflation component of 3% and a 0.25% per annum productivity increase assumption.

The most recent actuarial valuation of the PERF indicated that there was an unfunded actuarial accrued liability. The amount of the underfunded liability applicable to each agency or department cannot be determined. Trend information, which presents CalPERS progress in accumulating sufficient assets to pay benefits when due, is presented in the June 30, 2006, CalPERS CAFR.

## 8. TRANSFER FROM HOUSING AND EMERGENCY SHELTER TRUST FUND ACT OF 2002

The *Housing and Emergency Shelter Trust Fund Act of 2002* (“Prop 46”) is a \$2.1 billion dollar bond measure that was passed by the voters of California in November 2002. The bond provides monies to help fund the construction, rehabilitation, and preservation of affordable rental housing, emergency shelters, and homeless facilities, as well as funds that can be used to provide down payment assistance to low- and moderate-income first-time homebuyers. The Fund drew no funds in 2006 and \$958,903 in 2005 of the \$85 million allocated towards assistance in developing low-income housing from Prop 46. The remainder of the Prop 46 funds available for this purpose has reverted, and therefore, there will be no more draws by the Fund. These funds are invested and available to be utilized to pay claims as needed.

## 9. CONTINGENCIES

Certain lawsuits and claims arising in the ordinary course of business have been filed or are pending against the Fund. Based upon information available to the Fund, its review of such lawsuits and claims, and consultation with counsel, the Fund believes the liability relating to these actions, if any, would not have a material adverse effect on the Fund’s financial statements.

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